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ABSTRACT

Proposals for the amendment or elimination of the in-school interest subsidy for the Guaranteed Student Loan (GSL) program were evaluated. The proposals were assessed in terms of their effects on the administrative and operational aspects of the GSL program, the availability of loan capital, and their impact on borrowers' ability to meet their repayment obligations. The proposals fall into four categories: borrower paying of interest while in school; accrual and deferral of in-school interest; immediate payment of in-school interest through additional borrowing (Domenici plan); and recapture, during the repayment period, of the federal in-school interest payment from the borrower (Metzenbaum proposal). It was concluded that the elimination of the in-school interest subsidy would seriously erode the capital supply for the GSL program. Experiences of various states with nonsubsidized loan programs indicate that students will have great difficulty in meeting interest payment obligations during their in-school years. It is recommended that the GSL in-school interest subsidy be retained in its current form. The basic data source for the analysis is described, as are previous studies on student loan defaults (Cresap Study, Kuch Report, and the Educational Policy Research Institute Model Report). (SW)

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National Commission on Student Financial Assistance

STUDY OF PROCEDURES TO ELIMINATE THE GUARANTEED STUDENT LOAN IN-SCHOOL INTEREST SUBSIDY

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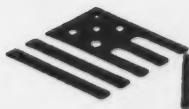
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National Commission on Student Financial Assistance

STUDY OF PROCEDURES TO ELIMINATE THE GUARANTEED STUDENT LOAN IN-SCHOOL INTEREST SUBSIDY



Scott Miller, Research Associate

NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE

The National Commission on Student Financial Assistance was created by Public Law 96-374, the Education Amendments of 1980. During the congressional deliberations on those amendments, the Congress realized there was a general lack of reliable information and well-informed policy recommendations on many of the most fundamental and important federal student assistance policy issues in postsecondary education. The National Commission was established to correct this situation and to serve as a reliable policy agent for the President and the Congress.

Established in 1981, the National Commission is a bipartisan panel of members of Congress, leaders in the higher education community and representatives of the public. The panel is composed of twelve members, four appointed by the President of the United States, four by the House of Representatives and four by the United States Senate.

The final report of the National Commission is due on July 1, 1983.

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EXECUTIVE SUMMARY

BACKGROUND

The in-school interest subsidy is a basic component of the Guaranteed Student Loan (GSL) program. By this subsidy, the federal government pays the interest on Guaranteed Student Loans during the in-school period, which is the time the student is enrolled in a postsecondary institution and the subsequent grace period before repayment begins. In fiscal year 1982, costs for the in-school interest subsidy totaled approximately one billion dollars or 35 percent of the cost of the entire GSL program.

In recent years, a number of proposals have been advanced to eliminate the in-school interest subsidy. These proposals fall into four basic categories:

- o borrower paying of interest while in-school;
- o accrual and deferral of in-school interest, with borrower paying both principal and interest after leaving school;
- o immediate payment of in-school interest through additional borrowing; and
- o recapture, during the repayment period, of the federal in-school interest payment from the borrower.

This study reviews these procedures in terms of the effect each would have on the administrative and operational aspects of the GSL program, the availability of loan capital, and the impact that each proposal would have on borrowers' ability to meet their repayment obligations.

FINDINGS

The report concludes that the elimination of the in-school interest subsidy would result in a serious erosion of the capital supply for Guaranteed Student Loans. Lenders faced with increased administrative workloads and reduced profitability would probably withdraw from the GSL program. Complications that would arise in secondary market transactions involving nonsubsidized loans would also result in reduced lender participation in the program. The interruption of cash-flow to lenders that would result from accrual and deferral plans would serve as a disincentive to GSL lending.

The experiences of various states with nonsubsidized loan programs, including the student portion of the PLUS program, indicates that students will have great difficulty in meeting interest payment obligations during their in-school years. Proposals that result in adding the amount of the in-school interest to students' repayment schedules will result in dramatic increases in total indebtedness. These increases in total debt can be expected to lead to higher rates of loan default and, consequently, higher federal costs for reinsuring these loans.

CONCLUSION

For all practical purposes, it is impossible to continue the Guaranteed Student Loan program as it is currently structured without the interest subsidy. From an operational and administrative viewpoint, eliminating the subsidy would have a disastrous impact on the program. The access of students to GSL capital could be seriously reduced if lenders withdrew from the program due to elimination of the subsidy. Students who would be able to secure these loans would encounter great difficulties in meeting payments either during the in-school period or in the course of repayment due to the increased levels of their indebtedness.

The in-school interest subsidy is a vital and irreplaceable component of the Guaranteed Student Loan program. Elimination of the subsidy would weaken the program's ability to provide students with access to low-cost capital to finance their postsecondary education. The National Commission on Student Financial Assistance (NCSFA) strongly supports the retention of the Guaranteed Student Loan in-school interest subsidy in its current form.

I. BACKGROUND

The National Commission on Student Financial Assistance (NCSFA) is required under Section 8 of Public Law 96-374 to conduct a study of the Guaranteed Student Loan in-school interest subsidy and proposals for its amendment or elimination.

With this legislative charge as its starting point, the Commission has interpreted its mandate to include a review of the proposals to eliminate the in-school interest subsidy being considered by the Congress and the Administration.

Since Public Law 96-374 was enacted, the GSL program has been restricted to students who can demonstrate financial need. Thus, in its consideration of the proposals requiring the federal government to "recapture," or recover, the interest subsidy, the Commission has recognized that all borrowers are obtaining loans because of need. As outlined below, all of the proposals to eliminate the subsidy have been considered in terms of their impact on capital availability.

THE GUARANTEED STUDENT LOAN PROGRAM

The Guaranteed Student Loan program is a federal program that assists students in securing loans to help finance their postsecondary education. Under this program, no loans are actually made by the federal government. Instead, the loans are made by a variety of lenders, and are guaranteed by the federal government. In order to encourage

lenders' participation, the federal government provides them quarterly "special allowance" payments so they may receive a fair yield on their loan capital. In addition, the federal government makes interest subsidy payments on behalf of student borrowers until the students begin repaying their loans, following a grace period period of six to nine months after they leave school. Today, the Guaranteed Student Loan program is the largest single source of student financial assistance in this country.

The vast majority of Guaranteed Student Loans are insured by state guaranty agencies that administer the GSL program. These agencies are then reinsured by the federal government for loans made under their auspices. State guaranty agencies also play a major role in locating capital to finance new loans.

To further encourage lending under the GSL program, Congress established the Student Loan Marketing Association (SLMA or Sallie Mae) as part of the Education Amendments of 1972, and the private corporation's role has since increased considerably. Sallie Mae's principal function is to serve as a secondary market or "warehouse" for student loan portfolios under the GSL program.

The GSL program was begun modestly under the Higher Education Act of 1965 to provide a widely accessible means of assisting low- and middle-income students to finance their postsecondary education. The program was also

originally proposed as an alternative to tuition tax credits, which were being considered by the Congress at that time. Over the years the program has grown, and during this growth the program has been expanded so that an increasing number of students have been made eligible for its benefits. By 1979, every American family, without regard to income, was eligible for a subsidized loan to aid in financing postsecondary education. More recent action by the Congress has concentrated on limiting eligibility for the program and reducing its cost to the federal government.

Since its inception, more than 18 million loans have been issued under the program totaling over \$30 billion. During the 1981-1982 school year, over 3.5 million students borrowed an estimated \$8 billion, averaging nearly \$2,300 per loan.

THE IN-SCHOOL INTEREST SUBSIDY

The in-school interest subsidy has been a key component of the GSL program throughout its history. During the time that a borrower is enrolled in a postsecondary institution on a half-time or more basis and during the grace period, the federal government pays the interest that accrues on a Guaranteed Student Loan. The in-school interest subsidy is paid directly to the lender on a quarterly basis. Under current program rules, the student borrower is not required to repay this subsidy. Originally, the program provided for federal payment of all interest throughout repayment as well as during school.

From time to time, proposals have been introduced to eliminate the in-school interest subsidy provision of the program. Thus far, such attempts have not been successful. Proposals to limit the number of students who would be eligible for the subsidy generally have resulted in confusion among program lenders and have jeopardized the amount of capital available to student borrowers.

One such proposal was included as part of the Education Amendments of 1972. This legislation required students to demonstrate financial need as a condition of receiving the interest subsidy on Guaranteed Student Loans. As originally drafted, these GSL "need" requirements were found to be vague and confusing. For most of the summer of 1972, lenders refused to make Guaranteed Student Loans for fear of violating some provisions of the law. Finally, in August 1972, Congress passed an emergency measure rescinding these new rules. Subsequent legislation and regulation provided that students with family incomes above the statutory ceiling could qualify for payment of in-school interest if the financial aid officer at the college or university documented that a student or family had special needs. Relatively few loans, however, were made on this documented special need basis. Prior to 1978, lenders had the option of issuing nonsubsidized loans to students whose family incomes exceeded the legislated income ceiling. During this time period, however, less than 5 percent of the Guaranteed

Student Loans made were issued without the in-school interest subsidy.¹

Federal Costs For The In-School Interest Subsidy.

Historically federal costs for payment of the in-school interest subsidy have constituted a significant proportion of GSL program costs. In 1973, for example, expenditures for in-school interest subsidy payments totaled nearly 70 percent of program costs. In recent years, as rising interest rates and increased numbers of outstanding loans have driven up the cost of the special allowance payments to lenders, the in-school interest subsidy has represented a declining proportion of federal GSL obligations.² This occurred despite a steady increase in the dollars devoted to subsidy payments.

Growth in federal payments for in-school interest obligations was modest throughout most of the 1970s:

	(in millions of dollars)							
<u>Obligations</u>	<u>1973</u>	<u>1975</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> <u>est.</u>
In-school Interest	\$203	\$216	\$225	\$249	\$296	\$445	\$ 834	\$1,000
Total GSL Obligations	303	474	532	705	978	1,576	2,723	2,857

SOURCE: U.S. Education Department

¹College Board, The Guaranteed Student Loan Program: Options for Controlling Federal Costs While Preserving Needed Credit for College (Washington, D.C.: College Board, 1981) p. B-3.

²For example, in 1977 special allowance payments accounted for approximately 20 percent of total GSL obligations. By 1981, that percentage had risen to over 55 percent. During the same period, in-school interest costs fell as a percentage of federal GSL obligations from approximately 42 percent to 30 percent.

The jump in these payments since 1978 can be linked directly to passage of the Middle Income Student Assistance Act and the Higher Education Technical Amendments of 1979, and the increase in loan volume that followed the enactment of these amendments.³ Similarly, these costs are expected to shrink as program volume decreases and current borrowers complete school and realize their repayment responsibilities.

Effects of Removing the Income Ceiling

Elimination of the interest subsidy income ceiling has had several major effects that explain the precipitous increase in Guaranteed Student Loan volume. More and more students from middle- and upper-income backgrounds have secured these loans once they became eligible to benefit from the in-school interest subsidy. Also, increasing college costs have forced more students to seek financial assistance.

In fiscal year 1978, slightly less than \$2 billion was lent under GSL. In the three succeeding fiscal years lending volume grew to \$3 billion in 1979, \$4.8 billion in 1980, and \$7.8 billion in 1981. Many of the individuals who have borrowed under the GSL program since 1978 are still

³Among the provisions of the Middle Income Student Assistance Act and the Higher Education Technical Amendments of 1979 were the elimination of all income requirements for GSL borrowers, changes in the special allowance formula designed to encourage greater lending.

students, and as a result, the amount of loans for which the federal government is making in-school interest payments has grown steadily over the past three years.

Removal of the income ceiling had other effects as well. Banks could bill the federal government for the in-school interest payments on all new loans, thereby allowing them to drop the previous system of double bookkeeping for subsidized and nonsubsidized loans. Despite the small number of nonsubsidized loans, the administrative aspects of maintaining separate accounts are both costly and burdensome. In general, lenders have become much more willing to participate in the GSL program. The dynamics of the GSL application process also changed. Students could walk into a bank and apply for a loan without their parents being asked to provide confidential financial information. Each of these factors contributed to the growth of GSL lending activity from 1978 to 1981.

Then, starting in fiscal year 1982, an income requirement was instituted for receipt of a Guaranteed Student Loan. Students whose family income exceeds \$30,000 must undergo a needs test to determine the amount of the loan (if any) for which they are eligible. There is some indication that GSL volume has fallen as much as 30 percent since the income cap and needs test were implemented. This reduction in borrowing will result in reduced federal costs for the GSL program in future years. Savings in special

allowance obligations have also been predicted, caused by a decline in the interest rates for U.S Government Treasury Bills.

RESEARCH METHOD

This examination of proposals to eliminate the Guaranteed Student Loan in-school interest subsidy focuses on the effects of such proposals on the administrative aspects of the GSL program as well as the impact on student borrowers. While it may be possible to eliminate the in-school interest subsidy for GSL borrowers and still maintain the Guaranteed Student Loan Program, it is also possible that such a measure could alter the scope and mission of the program. As part of its evaluation of proposals to eliminate the subsidy, this study examines the impact of in-school interest payment on overall levels of student indebtedness.

Many factors were examined in attempting to determine whether the existing GSL program could adapt to a drastic alteration in the in-school interest subsidy provision. As with all investigations into the GSL program, one must be aware of the wide range of participants in loan origination, processing, disbursement, servicing and collections. All of these participants and processes will be affected, one way or another, by alterations in the basic components of the GSL program and their interactions must, therefore, be carefully scrutinized.

In recent years, a number of proposals have been made to eliminate the GSL in-school interest subsidy. While all of these proposals have had a similar goal, to reduce the federal costs for the GSL program, not all have attempted to achieve this goal in the same way.

Presented below are the four basic mechanisms for eliminating the in-school interest subsidy that were examined as part of this study. These are the mechanisms recommended by the majority of the proposals to eliminate the subsidy.

Recapture.

Recapturing the in-school interest subsidy involves the federal government continuing to provide lenders with payment of the borrower's interest while the borrower remains in school, with the government intending to collect this money at a later date. This collection could either be conducted directly by the federal government or by adding the amount of interest paid to the borrower's regular payments, with the lender (or collection agent) then remitting this money to the federal government.

Accrual and deferral of interest payment.

This option entails the accruing of the borrower's in-school interest, with payment deferred until after the grace period. At that time, the in-school interest would be added to the payment schedule that covers loan principal and subsequent interest. Thus, lenders would receive no payment of loan interest until the start of the repayment period.

In-school payment of interest.

This scheme involves collecting the interest from the student directly while he or she is attending school. Payment of interest would continue until the end of the grace period. At that time, the student would begin repayment of the loan principal and all subsequent interest. Interest payments could be set to coincide with interest accrual. This would result in increasing payments as the student secured additional loans; that is, the interest due on an initial loan of \$2,500 would double if the student secured a \$2,500 loan the following year. Such an interest payment plan would be maintained by the lender for the student's entire postsecondary career even if additional loans were secured.

Immediate payment of interest through additional borrowing.

This plan permits students to borrow up to the maximum currently available under GSL and then to add to this loan the amount of interest to be paid while in school. The interest borrowed would be placed by the lender in a credit account for the student. While the student remained in school, the lender would draw against this account in order to collect the interest due. The student, once out of school and after the grace period, would have the amount of interest borrowed added to his or her principal repayment schedule.

The administrative and practical implications of all of these proposals were evaluated through the use of a variety

of research tools. Data collected as part of the Study of Special Allowance Payments under the Guaranteed Student Loan Program that was conducted for the National Commission on Student Financial Assistance⁴ was analyzed for information relevant to the current study. This allowed for a reliable estimate of lender reaction to elimination of the subsidy and is based on a national survey of GSL participants. This information was supplemented through informal discussions and in-depth interviews with additional lenders, servicers, secondary market officials, U.S. Department of Education personnel, and consultants. Guaranty agencies in New York, Pennsylvania, New Jersey, Washington State and Massachusetts also provided a great deal of information on the consequences associated with elimination of the in-school interest subsidy.

The desirability of maintaining the Guaranteed Student Loan program without the in-school interest subsidy was also examined. This measure of desirability will be a key factor for those charged with making decisions on this policy option. As stated previously, the in-school interest

⁴Wharton Applied Research Center, The Wharton School, University of Pennsylvania, A Review of the Guaranteed Student Loan Special Allowance: A Study of Alternative Incentives for Sources of Private Capital to Participate in Loan Programs for Postsecondary Education, prepared for the National Commission on Student Financial Assistance, June 30, 1982, vol.1, hereafter cited as Wharton GSL Special Allowance Study.

subsidy is a fundamental component of the program. Eliminating the subsidy may, then, have serious effects on the program's ability to serve its role in providing access and expanding opportunities for choice among postsecondary students.

The probable impact of the subsidy's elimination on student access to Guaranteed Student Loans and the repayment burden to be placed on borrowers has been examined. By again employing data gathered in the Wharton GSL Special Allowance Study, the effect on GSL capital supply can be better understood. A newly developed national data base of GSL borrowers and a model of student repayment burden illustrate the effect eliminating the subsidy will have on student borrowers. Thus we have an improved picture of the long- and short-term implications of eliminating the subsidy, and a much better context for examining policy choices in this area.

II. PROPOSALS TO ELIMINATE THE IN-SCHOOL INTEREST SUBSIDY

In the past three years, federal legislators and administration officials have proposed the reduction or elimination of the GSL in-school interest subsidy. The subsidy was targeted by all of these parties because of its significant costs to the federal treasury.

METZENBAUM AMENDMENT

One of the proposals given serious consideration during the 1980 Reauthorization of the Higher Education Act was advanced by Sen. Howard Metzenbaum (D-Ohio) who thought that student borrowers were being oversubsidized for their post-secondary pursuits. "Is there any logical reason," the Senator asked his colleagues, "why a student who has been able to go through college, graduate from college, go out and become a productive earner in the workplace, why that student should be subsidized by all of the rest of the people of this country?"⁵

Senator Metzenbaum's proposal called for "the repayment to the United States, after the beginning of the repayment period in installments during such period, of the full amount of the interest paid."⁶ This proposal, in short, called for the recapture of in-school interest by accruing

⁵Congressional Record, June 14, 1980, p. S7962.

⁶Ibid., p. S7961.

and deferring student payments of the interest due. Senator Metzenbaum argued that this was a necessary step to take in order to control the increasing costs of the GSL program. In a committee meeting shortly before the proposal reached the Senate floor, Senator Metzenbaum noted that many students were using the funds borrowed at low interest rates for purposes other than education. In a Senate Budget Committee meeting held later in the year, Sen. Ernest Hollings (D-S.C.), then chair of that Committee, echoed this thought when he claimed that students can "take out a federal loan, turn around and invest the money in a savings certificate and pocket the profit."⁷

Opponents of Senator Metzenbaum's proposal to eliminate the interest subsidy believed that such a step would have dire consequences on the GSL program's operations and the students it serves. Sen. Robert Stafford (R-Vt.) argued that the real effect of the subsidy's elimination would be a significant reduction in the number of students securing Guaranteed Student Loans. In statements on the Senate floor, Senator Stafford pointed out that the Congressional Budget Office (CBO) had estimated that GSL borrowing would drop by 50 percent. In fact, the bulk of the cost savings that CBO estimated would result from the proposal's adoption

⁷Higher Education Daily, September 5, 1980, p. 1.

were linked to the reduced level of "borrowing." Senator Stafford also cited research conducted by the American Council of Education (ACE) that estimated added administrative costs to the federal government of up to 66 cents per dollar of the interest recaptured under Senator Metzenbaum's proposal. Sen. Claiborne Pell (D-R.I.) summed up the opposition to the Metzenbaum amendment: "I believe the benefits acquired from this amendment, which might be a certain reduction in expenditure, are more than offset by the disadvantages that accrue from it."⁸

Senator Metzenbaum's amendment was originally rejected by the Senate Education Subcommittee. It was subsequently adopted by the full Senate as part of its 1980 Reauthorization Bill, but was eventually dropped from the measure during conference committee. As part of its action, however, the conference directed the National Commission on Student Financial Assistance to study the feasibility of eliminating the in-school interest subsidy.

DOMENICI PLAN

In 1981, Sen. Pete Domenici (R-N.M.), chairman of the Senate Budget Committee, introduced a proposal aimed at cutting the costs of the GSL program, which included the elimination of the in-school interest subsidy. Under the Domenici plan, students would be required to borrow the

⁸Congressional Record, June 24, 1980, p. S7962.

amount of the in-school interest in addition to the loan principal. Lenders would hold the interest amount in special accounts that they would draw against during the in-school period. Special allowance payments would be paid to the lender on the principal and interest amounts.

As of this date, neither the Senate nor the House have adopted this proposal. Statements released by the Senate Budget Committee emphasized the cost savings that it would achieve as the primary argument for its consideration. Numerous higher education groups responded to the proposal by pointing out the significant impact that its implementation would have on overall student indebtedness and ability to repay Guaranteed Student Loans. It was also predicted that borrowing would drop significantly if this proposal was adopted.

PROPOSALS BY CARTER AND REAGAN ADMINISTRATIONS

Both the Carter and Reagan Administrations have, at various times, included the elimination of the in-school interest subsidy as part of their efforts to hold the line on GSL program costs. Again, these proposals have not been accepted by the Congress.

The proposal advanced by President Carter as part of his fiscal year 1982 budget called on Congress to "eliminate the 9 percent interest subsidy now provided to students

while they are in school."⁹ This proposal was part of a package of GSL reforms offered to curtail the rising costs of the program. In its rationale for proposing these program revisions, the Office of Management and Budget (OMB) expressed its fear that GSL costs would continue to skyrocket because of the increased borrowing following passage of the Middle Income Student Assistance Act. OMB claimed, at that time, that GSL volume was expanding at a greater rate than had been expected before the eligibility rates were relaxed.

In his revision of the President's budget request for 1982, President Reagan included the following under his planned reform of student aid programs:

The current in-school interest subsidy for student loans, which the Federal government pays the lender until the student begins to repay the loan, will be eliminated. Instead of receiving a Federal subsidy while the student is in school, or a deferment or grace period, the lender will be allowed to add the student borrower's accruing interest to the principal amount. Alternatively, the lender can require the nine percent interest to be paid by borrowers as it accrues. The student loans will still be guaranteed by the Federal government which will continue to pay the special allowance to lenders of student loans.¹⁰

⁹U.S. Department of Education, Fiscal Year 1982 Budget, (Washington, D.C.: U.S. Government Printing Office, March 10, 1981).

¹⁰U.S. Department of Education, Revised Fiscal Year 1982 Budget, (Washington, D.C.: U.S. Government Printing Office, March 10, 1981).

In the details that accompanied the submission of these proposals to Congress, the Reagan administration and the Office of Management and Budget argued that:

Without these reforms, the GSL program would be recklessly expanded in a few years. Under the GSL programs, students can borrow regardless of their educational need, with the federal government paying all interest on the loan until the student is out of school. The result is that the federal government pays high rates of interest on free money that students spend as they see fit.¹¹

Although Administration proposals were directed only at eliminating the in-school interest subsidy, OMB went on to charge that students and families are investing student loan principal in high-yield certificates while the federal government is subsidizing these loans. "Without rational limitations, such as the Administration is proposing," OMB charged, "the Department of Education could soon become the creditor of the first resort for every American family that has a family member enrolled in postsecondary education."¹²

In its budget proposals for fiscal year 1983, the Reagan administration dropped the idea of eliminating the in-school interest subsidy. Instead, it proposed savings in GSL costs through, among other measures, the shifting of graduate students to the PLUS program and doubling the loan origination fee.

¹¹U.S. Executive Office of the President, Office of Management and Budget, Additional Details on Budget Savings: Fiscal Year 1982, (Washington, D.C.: U.S. Government Printing Office, 1982), p. 103.

¹²*Ibid.*, p. 103.

III. THE IMPACT OF ELIMINATING THE IN-SCHOOL INTEREST SUBSIDY ON THE OPERATIONS OF THE GSL PROGRAM AND CAPITAL AVAILABILITY

BACKGROUND

In evaluating the probable effects of the various proposals to eliminate the in-school interest subsidy, administrative and operational considerations must be examined in depth. This is an area of the GSL program that is often overlooked in the course of making program policy decisions. Clearly, all of the major administrators of the GSL program--the federal government, state guaranty agencies and private lenders--would be affected by alterations in the in-school interest subsidy.

Lender Participation

As with many areas where changes have been proposed in the structure of the GSL program, the elimination of the in-school interest subsidy may have an impact on the number of lenders participating in the GSL program. The degree of lender participation is a crucial aspect of the program especially in terms of its serving the needs of postsecondary students. The intent of the GSL program is to provide access to loan capital to all eligible students. Proposals that would result in reduced availability of loan capital will limit the ability of the program to assist needy postsecondary students.

Capital for lending under the GSL program is provided by private lenders (banks, credit unions, postsecondary

institutions, insurance companies) through agreements with state guaranty agencies and the U.S. Department of Education. Lenders are under no legal requirement to issue Guaranteed Student Loans; they participate for a number of reasons depending on their individual circumstances. Historically, lenders have shown that their level of participation may vary, given certain alterations in the program.

In recognition of the tenuousness and importance of lender participation in the program, Congress has taken a number of steps to encourage lender commitment to the GSL program. These measures have been crucial in meeting the rising demand for Guaranteed Student Loans in recent years.¹³ Many of these measures have involved either increasing or ensuring, or both, the level of profit that lenders earn from GSL issues. For example, the cap on special allowance payments was lifted so that lenders would not get caught short in times of high interest rates. Other measures have concentrated on enhancing the role and position of state guaranty agencies as a means for increasing the availability of loan capital in each of the states. In 1976, for example, state agencies were granted the ability to collect 100 percent of the value of the defaulted loans

¹³A detailed history of the legislative development of the program is included in National Commission on Student Financial Assistance, Guaranteed Student Loans: A Background Paper (Washington, D.C.: National Commission on Student Financial Assistance, March 1982).

that they insure as long as their overall default rate is held below established levels.

In the summer of 1972, lenders had reacted negatively to a series of amendments to the GSL program. One of these changes required that borrowers meet a needs test before they were deemed eligible to receive subsidized loans. Lenders at that time balked at the prospect of having to monitor and implement such a system and virtually ceased lending under the GSL program. About two months later, Congress was forced to pass an emergency measure rescinding these rules, and lenders once again began issuing the loans. Thus, lender participation in the GSL program must be closely monitored when changes are considered. Alterations to the program that would affect an institution's GSL portfolio, the profit it makes on GSL loans, or the administrative requirements of the program may be especially likely to meet with adverse reaction from lenders.

Administrative Considerations

The administrative implications of proposals to alter the GSL program must be carefully considered. In weighing the feasibility of eliminating the in-school interest subsidy and assessing the relative merits of alternative proposals, the consequences of such action on the manner in which the program is administered at all levels must be fully understood.

There are three major participants in the GSL program that have both the prime responsibility for administering the program and that would be most concerned with plans to eliminate the subsidy. They are the lenders, the state guaranty agencies and the secondary markets that buy loans from the original lender and assume all responsibility for servicing. Postsecondary institutions, especially financial aid offices, are also involved in administering the program. Although their roles and responsibilities would not change appreciably if the in-school interest subsidy were eliminated, institutional financial aid offices may be faced with the challenge of building in-school payments into student budgets and packaging other aid to cover these payments.

The administrative implications of changes in the GSL program need to be examined at all stages of the loan process. The origination of a loan, its maintenance during the in-school period, and the servicing of that loan during repayment are the three basic stages that a loan must go through and that involve specific administrative procedures, techniques and expenses. Of course, lenders and state guaranty agencies will be much more involved in loan origination than secondary markets. In maintenance and servicing areas, though, they may all be involved.

The federal government is, of necessity, a major partner in the administration of the GSL program. Any proposal that results in basic changes to the GSL program especially in the

area of lender payments, will cause alterations in the administration of the program. New billing procedures, keeping track of a new category of loans (such as, nonsubsidized) and the potential for escalating default will place a strain on the Department of Education's ability to properly administer the program and manage its resources.

The question of costs is inherent to all of the discussions on increased administrative responsibilities and of critical interest to all participants in the GSL process. Proposals to cut federal government costs may not achieve this objective if the costs of implementing and maintaining the changes outweigh the expected savings. Proposals that shift federal costs to the states or result in major additional costs to be borne by the state guaranty agencies are impractical given the difficulty many state agencies encounter in attempting to secure funding from their respective state legislatures. And, proposals that would necessitate increased expenditures by lenders, thus reducing their profitability in the program, could have adverse effects on the amount of capital available to students.

It is impossible, for all practical purposes, to derive exact estimates of the costs of implementing and administering over time various proposals to amend the GSL program. Lenders, in many cases, do not have a clear idea of the costs associated with the administration of the program. Since many of the functions that lenders perform as part of their

management of Guaranteed Student Loans are spread throughout different areas of lending institutions it is unlikely that reliable estimates of the costs of such a function can be arrived at. The majority of lenders have never attempted to identify current costs and none were found who could provide accurate accounts of the costs for proposed changes to the existing system.¹⁴

Additionally, there is wide variance in the practices of lenders and others involved in servicing student loans. The sophistication of data processing systems, the costs associated with them, and the specific procedures they require vary from institution to institution.

FINDINGS

To evaluate fully the impact of eliminating the in-school interest subsidy on the operations of the Guaranteed Student Loan Program, information is presented below according to participants in the loan process--lenders, secondary markets and state guaranty agencies. Each of these areas will be discussed in terms of their administrative responses to each proposal to eliminate the subsidy presented in Section II.

¹⁴For a more detailed discussion of the manner in which lenders keep track of the costs associated with administering the GSL program and for estimates of the current costs of program management see Wharton GSL Special Allowance Study.

Lenders

As with any area of change in the Guaranteed Student Loan program, the greatest impact will be felt by lenders. Those institutions that supply capital for Guaranteed Student Loans carry the greatest portion of the administrative burden of the program. The exact share of that burden varies according to each lender's relationship with secondary markets, and the services the lender receives from its state guaranty agency.

The in-school interest subsidy is an important factor in lenders' willingness to participate in the GSL program. In the Wharton GSL Special Allowance Study,¹⁵ over 80 percent of the lenders included the in-school interest subsidy, along with the special allowance and the federal guarantee, as highly influential in shaping their GSL lending policy. Lenders of all sizes and levels of participation in the GSL program responded in this manner. Additionally, lenders of large- and small-asset size said they would reduce or stop lending should the subsidy be eliminated, especially during a time of declining rates.

The primary reasons cited by lenders for their adverse reaction to eliminating the in-school interest subsidy are administrative. Depending on the proposal considered, the nature of these reasons varies. What also varies is the

¹⁵Ibid.

place in the lending process in which administrative concerns are centered.

All of the basic proposals to eliminate the subsidy would result in altering the procedure by which student loans are originated. The proposals requiring student payment of interest while in school and requiring borrowing of the in-school interest subsidy would have the greatest affect on the origination of loans.

Servicing. Paramount among lenders' concerns about proposals having students pay interest while in school is the very act of collecting that in-school payment. The first step in that collection effort, according to most lenders and state agency representatives consulted, would be the imposition of a test to determine the ability of student borrowers to meet payments during that period. This test would be similar to the test employed to establish the creditworthiness of individuals applying for consumer loans (such as, auto, home improvement). The use of such tests would have a major impact on the GSL program. First, the costs to lenders of originating student loans would increase markedly in order to cover the costs of performing this credit test. Since the credit histories of students may be considerably less complete or easy to discern from those of regular bank customers, or both, the cost and complexity of checking student borrowers for creditworthiness could be greater than normal. Lenders may opt to endorse only those

student loan applications that have endorsers or cosigners. Administrative expenses would increase under this procedure in order to process the extra data needed from the cosigner and perform a credit check on the endorser.

Lenders assume that under such a situation they would process a great many more applicants than they would approve. Students who are young, have little credit history, and have small or no expected sources of discretionary income during the in-school period would, more often than not, fail standard credit evaluations. The result of these increased administrative measures would be to deny numerous students access to loan capital from private lenders. In the Wharton GSL Special Allowance Study, state guaranty agency personnel and lenders familiar with the GSL program and its borrower population, queried the ability of students, especially self-supporting students, to obtain cosigners for loans that demand interest payment immediately after origination.

The PLUS program, specifically its graduate student component, sheds some light on the potential impact of proposals to eliminate the subsidy. One large state guaranty agency that has actively attempted to recruit PLUS lenders notes that lenders are balking at the idea of issuing loans that require the borrower to pay interest during the in-school period. Only a dozen loans have been issued in that state to students without a deferral of

interest payments and all of those loans have had creditworthy endorsers. Further complications arise in areas where GSL payments are made in multiple disbursements. Interest payments would need to be altered each time a disbursement is made, causing additional complications for payment behavior.¹⁶

In testimony presented at a hearing conducted by the In-School Interest Subsidy Subcommittee of the National Commission on Student Financial Assistance, Philip Rever, vice president of the Higher Education Assistance Foundation (HEAF), provided preliminary statistics concerning the rate of delinquency among nonsubsidized PLUS Loan borrowers in the District of Columbia. Data collected by the Higher Education Loan Program of Washington D.C. (HELP-DC, a HEAF affiliate) suggests that students are encountering substantial problems in meeting their in-school payment obligations. While these data may not be applicable to a nonsubsidized GSL program, they provide insight into the problems encountered while attempting to provide nonsubsidized loans to students. The following is a summary of the HELP-DC experience:

- o At any given time about one-quarter of all of HELP-DC's student PLUS borrowers are 30 or more days delinquent.

¹⁶Some states, lenders and postsecondary institutions are using multiple disbursements in an attempt to reduce loan default. Portions of the total loan amount are released to the student two, three, four or more times during the year as academic progress is made and enrollment is confirmed.

o HELP-DC's student borrowers tend to move in and out of delinquency status.

o Four months after one group of loans were disbursed, almost half were 30 or more days delinquent while 17 percent were technically in default.

Most of HELP-DC's PLUS borrowers have only taken out one PLUS loan to date and are required to pay approximately \$35 per month. Subsequent borrowing would push this payment up to approximately \$140 per month for a student with \$12,000 in cumulative PLUS borrowing. While HELP-DC has not performed credit checks on its PLUS borrowers, it does require an extensive personal interview prior to disbursement.

According to Mr. Rever,

HELP-DC is confident that its default rate will decline over time as it becomes more effective in its collection efforts. However, it seems unlikely that delinquency rates will substantially decline as borrowers' incomes and expenses tend to vary from month to month. The tendency of these students to move in and out of "delinquent" status costs HELP-DC considerable sums.

HELP-DC indicates that servicing costs for PLUS loans to students are 150 percent greater than for subsidized Guaranteed Student Loans loans during the in-school period.¹⁷

Lenders and state agency officials interviewed for this study are in general agreement that attempting to collect interest payments from borrowers while they are still enrolled

¹⁷National Commission on Student Financial Assistance, Transcript of proceedings of In-school Interest Hearing, Washington, D.C., December 17, 1982, pp. 51-55.

as students is a potentially difficult task. There is widespread concern that a considerable number of student borrowers will become delinquent and that many of those will be forced into default during the in-school period. The experience of lenders and state agencies with nonsubsidized loan programs bears out this concern.

Two states, New York and New Jersey, provide the proper historical context for examining the problems that students have in meeting in-school interest payments. In 1960, New Jersey established a nonsubsidized student loan program. In response to questions raised specifically for this analysis, William Nester, Deputy Assistant Chancellor of the State of New Jersey Department of Higher Education, provided the following insight into that program's history:

By the time the Higher Education Act of 1965 was enacted [New Jersey] had already experienced several years with a student loan program quite similar to the GSL program (GSLP). [At that time,] the New Jersey program was beginning to face severe money access problems because lenders were experiencing extreme difficulty in collecting interest on these loans while the students were in school. We were able to turn the tide when GSLP was implemented because of the ease lenders had in collecting interest due. Of all the problems the [New Jersey State Higher Education Assistance Authority] experienced at that time, the matter of interest collection from students during the in-school period was the most critical and was the cause of many lenders' withdrawal from the program.¹⁸

¹⁸William Nester, New Jersey Department of Higher Education, Response to State Garanty Agency Protocol of June 1982, In-school Interest Subcommittee file, NCSFA.

New York State's experience with a program making nonsubsidized loans to students in the health professions has a similar history. Vast problems have been encountered in attempting to collect interest payments from students while they are still enrolled in school. In order to relieve lenders of the expense and burden of in-school collection, the New York State Higher Education Services Corporation (HESC) performs these billing and collection functions for the lender. HESC officials cite this service as a crucial incentive for lenders to issue loans under this program. Without this service there would not be enough private capital available to operate the program. While the resources of the New York State agency, one of the nation's largest, allow it to perform these services, they are beyond the means of most guaranty agencies.

Advising students of rule changes. Under all the proposals to eliminate the subsidy, lenders would be faced with increasing responsibilities to inform borrowers of the complexities of the program rules. The proposal to require student borrowing of in-school interest and the plan to have students accrue the amount of in-school interest carry with them a difficult task of informing student borrowers of their future repayment obligations. Students' fundamental understanding of the program would have to be altered so that they would not be forced into default or become delinquent based on misconceptions regarding the amount they will be expected to repay.

Increased costs. For lenders that have to originate nonsubsidized Guaranteed Student Loans, additional costs and complications would arise immediately following the act of originating such loans. In order to begin the process of loan collection immediately after disbursement, lenders would have to be equipped to post new loan accounts and to begin billing within a relatively short period of time.¹⁹ As research conducted as part of the Wharton GSL Special Allowance Study revealed, most lenders use data processing systems of varying levels of sophistication to manage their loan accounts and to perform servicing functions.²⁰ The retooling of computer software to convert loans to repayment in a more rapid fashion is an expensive process and may involve additional investment in computer capabilities. Many small-asset lenders, important contributors to the supply of Guaranteed Student Loan capital, may be unable to meet the demands of such an investment while others may be unwilling to spend the funds. The largest lenders, with data processing staff already in place and with larger computer capabilities, may, however, make this transition rather smoothly. The impact of this facet of eliminating the subsidy would be dependent on the lender's present

¹⁹Even if the first payment is not due until 60 days after origination (as is the rule under the PLUS program) the first bill would need to be sent in approximately four weeks in accordance with normal banking practices.

²⁰Wharton GSL Special Allowance Study.

system and practice. The overall effect would be to increase the program's reliance on a small number of large lenders which may cause problems in terms of student access to GSL capital.

The Wharton GSL Special Allowance Study noted that the decision-making processes of lending institutions regarding the operation of the student loan program differed from institution to institution.²¹ This may be cause for the varying capacities of student loan branches in obtaining the resources within the lending institution necessary to make such changes.

Under proposals to eliminate the subsidy, costs will also have to be incurred for redesigning accounts systems. The proposal requiring the borrowing of interest and the setting up of a special interest account for the lender to draw upon would necessitate an entirely new accounts system and a more accurate manner of keeping track of a student's in-school status. Should the student borrower leave school early, the amount credited to the interest account would then have to be credited as a payment towards the loan principal. The mechanism for monitoring and enacting these transfers would be quite complex to design and maintain. Similar concerns apply to the proposal requiring the deferral and accrual of in-school interest; closer attention

²¹Ibid.

would have to be paid to the borrower's in-school status and the accumulated amount of in-school interest continually calculated.

The costs associated with servicing student loans will be significantly affected by proposals requiring the payment of interest during the in-school period. The expenses associated with billing borrowers and posting their payments are the same whether for large or small payments. Generating the bill, postage, tracking of borrower response, the issuance of follow-up notices, and the crediting of payments received are all fixed costs for the loan servicer. The fact that billings for in-school payment would involve relatively small amounts of money, especially for first-time borrowers, indicates that lenders would need to spend a greater proportion of the amount being billed in order to collect than is currently the case under the GSL program. Such circumstances would greatly cut into the level of profit achieved by lenders on their student loan investments, thus making the program less attractive to lenders.

In addition to an increase in the proportional cost of servicing student loans, lenders would experience a precipitous rise in the total costs of servicing those loans. The in-school period is the most profitable period for lenders holding GSL notes.²² Under current rules, very little effort

²²Ibid.

is required to maintain student loan portfolios during this period. The prime responsibilities of lenders while the loan is in in-school status are to verify the continuing enrollment of the borrower and to include the loan as part of its billings for federal payment of special allowance and in-school interest on a quarterly basis. If the borrower secures new loans in subsequent academic years these totals are simply posted to the existing account. The reduced level of expenditures that must be devoted to servicing student loans during the in-school period is a prime factor in assuring lenders reasonable and, from their perspective, acceptable levels of profit on GSL issues.

The congressional and administration proposals to eliminate the subsidy would add to the costs of in-school servicing. Payment of in-school interest would necessitate the performance of a number of tasks not now required of student loan lenders, namely:

- billing students for interest during the in-school period;
- posting these payments to student accounts on a quarterly or monthly basis;
- additional verifications of enrollment status;
- increased skip-trace activity during the in-school period;
- frequent updating of student address changes; and
- the immediate generation of new payment schedules as additional loans are secured by the borrower.

Delinquency--real and potential. The result of large-scale delinquencies during the in-school period will be another increase in costs to loan servicers. Servicers are required to exercise due diligence in the collection of student loans, which involves making serious attempts to collect monies owed from delinquent borrowers. This may entail additional billings, mailgrams, skip-trace actions to locate borrowers who may be trying to avoid repayment, negotiating new payment schedules with borrowers experiencing temporary or unforeseen hardships, contracting with collection agents, and instituting legal action. All of these measures cost servicers a considerable amount of time and dollars, thus diminishing the profit gained from student loan portfolios. In addition, lenders incur costs each time they must prepare and file a default claim.

Questions would also arise on the treatment of applications for new loans from borrowers who have encountered problems in meeting their in-school interest obligations. Lenders may be forced to enact stricter standards for such borrowers or perform more pre-origination counseling in order to alleviate potential repayment problems. Borrowers with histories of delinquent in-school interest payments may be denied access to new loans.

High rates of delinquency within the student loan program have always served as a disincentive to lender participation. Problems encountered in loan collection from

borrowers under the Federally Insured Student Loan Program (FISL) are seen as major reasons for lender unwillingness to lend under FISL's auspices. In numerous regions of the country during the middle and late 1970s student loan capital was not available because of lender reluctance to participate in the FISL program. At that time, FISL carried with it a higher than average expectation of borrower delinquency and default. It can be assumed that a proposal that results in increased borrower delinquency or default, or both, will adversely affect lenders' decisions to continue their GSL participation, thus reducing students' access to loan capital.

Consultations with GSL lenders in Pennsylvania revealed that the costs associated with collecting interest from students during the in-school period would be approximately \$50 per year per loan. This does not include the extra costs associated with servicing delinquent or "problem" accounts.²³

Profits. Proposals requiring the accrual and deferral of in-school interest payments would also have serious effects on lender profits under the GSL program. Lenders depend on the cash flow generated by in-school interest payments to cover their expenses during the in-school

²³Jay Evans, Pennsylvania Higher Education Assistance Agency, Response to State Guaranty Agency Protocol of June 1982, In-school Interest Subcommittee file, NCSFA.

period, including a recouping of the costs incurred during the origination of student loans. In response to inquiries from Commission staff, Jay Evans, Deputy for Loans for the Pennsylvania Higher Education Assistance Agency, a state that has a very active student loan program, described the potential impact of such proposals:

Lenders would need to establish special accounting systems and procedures to accumulate interest and keep appropriate audit trails. There would be a negative cash flow on the funds invested in student loans and this would impact adversely on lender dedication of funds to be invested in a student loan portfolio.²⁴

Another state agency official hypothesized that lenders would not participate in the program "unless interest were allowed to be capitalized at least annually." All of the agencies contacted during this study agreed that lending would virtually halt or be reserved only for the best bank customers should the accrual and deferral proposal be implemented.

Secondary Markets

All of the proposals to eliminate the Guaranteed Student Loan program in-school interest subsidy will affect the relationship between lenders and secondary markets. The existence of secondary markets is a crucial factor in lender participation in the GSL program. The Wharton GSL Special Allowance Study revealed that the availability of these

²⁴Ibid.

markets has been increasingly important to lenders as the program has grown in size. Over 45 percent of the lenders surveyed as part of that study indicated that access to secondary markets was a very important (23 percent) or important (22 percent) factor in determining their level of GSL participation.²⁵

The largest lenders noted that the existence of adequate secondary market opportunities was a crucial factor to them whether or not they were current users of these services. Since large lenders issue the majority of Guaranteed Student Loans, any alterations in the relationships between lenders and secondary markets could have a major negative impact on the supply of GSL capital.

Lenders rely on secondary markets in large part to reduce the burden on their institutions of servicing student loans during the repayment period. Lenders often sell loans to Sallie Mae, state, or other secondary markets in order to generate capital with which to issue new student loans. Commonly, lenders sell that portion of their loan portfolios that is entering repayment to secondary markets before they incur the extra expense and burden of servicing the loan while it is being repaid. However, the increased cost of originating student loans and administering them during the in-school period that would result from elimination of the interest subsidy may prompt more lenders to seek secondary market buyers for loans immediately after origination.

²⁵Wharton Center Special Allowance Study.

As part of this study, an official with one of the largest state guaranty agencies in the nation described the probable impact of proposals to eliminate the subsidy on secondary market activities:

The costs for servicing in-school and grace period loans would increase through the elimination of interest subsidy and the secondary market (SLMA) would most likely increase its required average balance per borrower for loans to be purchased at par value (the dollar value of the loan portfolio). This would deter lender interest in small balance loans (short-course trade and nursing schools, low-cost community colleges) and when principal amount borrowed is discounted at time of sale, this could "chill" lender interest in all participation in educational loans.²⁶

This guaranty agency official's expectation is supported by recent experience under the PLUS Loan program. The Bulletin (May/June 1982), published by the U.S. Department of Education's Office of Student Financial Assistance, noted problems concerning the reluctance of Sallie Mae to purchase nonsubsidized parent loans. "The fact that repayment for the parent borrower must begin within 60 days of disbursement," explained The Bulletin, "presents problems for Sallie Mae."²⁷ According to officials with Sallie Mae, this problem is not unique to their operation and will be encountered in all secondary market transactions involving nonsubsidized loans.

²⁶Evans, Response to Protocol, June 1982.

²⁷U.S. Department of Education, Office of Student Financial Assistance, "The Bulletin" (Washington: U.S. Government Printing Office, 1982), p. 2.

Other state agency officials agreed with the assessment presented above. One agency predicted that the overall demand for secondary market liquidity "would be increased tremendously due to lenders wanting to sell off sooner in an effort to reduce their servicing costs."²⁸ But, he cautions, secondary markets may be reluctant to buy off large numbers of nonsubsidized loans since their "yield . . . would be reduced drastically." Another agency representative points out that secondary markets would be reluctant to purchase nonsubsidized loans during the in-school period because of "increased servicing costs . . . and decreased predictability of cash flows,"²⁹ concerns similar to those of lenders. These problems would be exacerbated for state secondary markets that finance their operations through the use of tax-exempt securities. Under law, they are entitled to only one-half of the applicable special allowance.

Problems would also arise regarding the availability of enough secondary market resources to satisfy lender desire to sell larger and larger portions of their GSL portfolio. The existence of secondary markets has provided a major incentive for lenders to participate in the Guaranteed Student Loan Program. If the interest subsidy is eliminated,

²⁸Nester, Response to Protocol, June 1982.

²⁹Joseph Cronin, Massachusetts Higher Education Assistance Corporation, Response to State Guaranty Agency Protocol of June 1982, In-school Interest Subcommittee file, NCSFA.

complications would arise for secondary markets. Under an accrual and deferral plan, they would lose the cash flow necessary to finance and maintain their operations. If payment of interest is demanded from the borrower during the in-school period, the secondary market would encounter problems in the timing of any transaction due to the short time between loan origination and the first payment, and will have to bear or pass onto the lender the increased costs of servicing. In either case, there would be a serious risk of reducing the access of lenders to secondary market services. This, in turn, could seriously reduce the supply of capital available to student borrowers.

Problems with secondary market access may be especially critical to students attending proprietary and two-year schools. Because of the short-term nature of these programs borrowers do not accumulate large amounts of GSL debt. Small average loan balances are not attractive to secondary market purchasers. In a letter to the National Commission on Student Financial Assistance, Stephen Friedheim, President of the Association of Independent Colleges and Schools (AICS) elaborates on this problem.

Our experience at AICS institutions . . . indicate[s] that the availability of a secondary market . . . is a primary incentive for the banks to participate in the GSL program. An elimination of the in-school interest subsidy would probably result in the removal of secondary market access for many lenders who make loans to proprietary students. This occurs because the average loan portfolio is much smaller than the portfolio of a student attending a four-year institution,

therefore, the economies of scale which often result from a larger loan balance do not come into play for a student participating in a short-term program. . . .

Even with the current payment of the in-school interest subsidy by the federal government, the portfolio size . . . established by Sallie Mae . . . has a detrimental effect on lending to students at AICS institutions. During the past several years, some lenders have even decided not to lend to proprietary school students because of this high loan portfolio size requirement, and we have every reason to believe that elimination of the subsidy will exacerbate that problem.³⁰

Many of the points stated by Mr. Friedheim are also applicable to students at community and junior colleges as well as vocational, technical and career schools.

Guaranty Agencies

State guaranty agencies will be among those affected by proposals to eliminate the GSL in-school interest subsidy. These agencies, which play a major role in ensuring the efficient operation of the GSL program, will be assigned additional responsibilities should the subsidy be eliminated.

Among the primary responsibilities of guaranty agencies is the dissemination of program information. Obviously, any major change in the GSL program, such as eliminating the subsidy, would require a major education effort on the part of the various guaranty agencies. Lenders, academic institutions, servicers and borrowers would all need to be

³⁰Stephen B. Friedheim to Scott E. Miller, December 6, 1982, In-school Interest Subcommittee file, NCSFA.

informed of the details and implications of such a major change in the program's rules.

New promissory notes, sample repayment schedules, thorough explanations of borrower rights and responsibilities, and guarantee requirements would need to be developed, printed, and distributed by the agency. Agencies would be forced to absorb the costs for all the staff time, reproduction and dissemination of materials involved in these activities.

Agencies that routinely perform other servicers for GSL lenders (such as, billings, preparation of federal reports) would have to assume a greater workload. Other agencies indicate that they may have to adopt all or some of these services in order to maintain lending in their states under a nonsubsidized loan program.

Historically, guaranty agencies have played a major role in recruiting and sustaining high levels of GSL capital availability in their respective jurisdictions. Agencies will be pressed to their limits to provide the services, information and support needed to keep lenders in the program. In states such as Colorado and Washington, the guaranty agencies have had to actively recruit lenders to participate in the GSL program. Officials in these states report that the in-school interest subsidy is a major attraction for lenders wary of providing capital to student borrowers. The ability of guaranty agencies to maintain and

develop an adequate level of GSL capital in their states will be severely challenged if the subsidy is eliminated.

All of the measures stated above will result in increased expenses to be borne by the many guaranty agencies. This will impose a severe hardship on these agencies. Most receive no state appropriation³¹ at all and must support themselves through the Administrative Cost Allowance (ACA) paid to them by the federal government and through fees charged to the borrower. The ACA received by an agency cannot exceed one percent of the total annual lending in that state. Should the subsidy be eliminated and lending volume drop appreciably (as is quite likely due to student reluctance to borrow and the probable withdrawal of a number of participating lenders) agencies could find themselves in a fiscal bind. While their administrative costs are rising at a rapid rate, their ACA payments, origination fees and insurance premiums will be shrinking. Agencies will have nowhere to turn except to the student borrower to make up for this shortfall. At a time when lenders, students, and the federal government are turning to the state agencies for support, the agencies may be forced to cutback or curtail crucial services. The likely result,

³¹According to quarterly report data submitted by state guaranty agencies to the Department of Education only 14 agencies received state appropriations in fiscal year 1981.

is that lenders, especially, will become frustrated by the situation and be reluctant to continue their participation in the GSL program.

IV. IMPACT OF PROPOSALS TO ELIMINATE THE GSL IN-SCHOOL INTEREST SUBSIDY ON BORROWERS

Attempting to gauge the impact of eliminating the in-school interest subsidy on borrower behavior is not a simple task. Unfortunately, there is a lack of empirical data upon which to base such an effort.

The U.S. Department of Education, and its predecessor, the U.S. Office of Education within the Department of Health, Education and Welfare, have not succeeded in understanding the repayment behavior of GSL borrowers. Since the publication of the Cresap Study and Kuch Report,³² in the late 1970s, the federal government has not commissioned any studies of this aspect of the GSL program.

NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE RESEARCH METHODS

In order to examine the probable effects of eliminating the in-school interest subsidy on student borrowers, the Commission used two data resources. The first is a new data file assembled by the U.S. Department Education that contains

³²U.S. Department of Education, Office of Planning, Budgeting and Evaluation, A Study of Selected Educational Institutions and Federally Insured Student Loan Programs, by Cresap, McCormick and Paget. (Washington D.C.: U.S. Department of Education, 1979), hereafter cited as Cresap Study; and U.S. Department of Education, Office of Planning, Budgeting and Evaluation, Postsecondary Programs Division, Predicting Default and Bankruptcy: Factors Affecting the Repayment Status of Student Loans, by Kuch, Peter J. (Washington: U.S. Government Printing Office, 1978), hereafter cited as Kuch Report.

records of some 5 million Guaranteed Student Loan borrowers since 1965 who are currently in various stages of borrowing (such as, in-school, deferral, repayment, default). These student records were provided to the Department of Education by the many guaranty agencies and were assembled into what has been nicknamed the "state dump" tape. The second resource was a model developed by Richard Wabnick of the Education Policy Research Institute (EPRI) under contract to the Department in 1977.³³ This model attempts to examine the impact of the student loan burden on the overall financial condition of the borrower by expressing loan debt as a percentage of overall discretionary income. While these resources did not provide crystal clear answers to the questions being considered, their use has shed considerable additional light on this matter.

FINDINGS

Review of Previous Studies (Cresap Study and Kuch Report)

Several years ago, the Department of Education carried out two studies on student loan defaults. Although the reports are somewhat limited in terms of technique and data used, their results suggest relationships that warrant further investigation.*

*A number of states have conducted limited analyses of borrower behavior, but these are neither conclusive nor reliable measures of national trends in repayment behavior.

³³Education Policy Research Institute, "Indebtedness to Finance Postsecondary Education," (HEW #300-79-0823) (Washington: U.S. Government Printing Office, 1981).

The Cresap Study, covering 510 direct federally insured student loans in nine colleges, found two factors to be the strongest predictors of loan defaults: nongraduation and being black. The probability of default also increased for those students of low income families who held relatively large loans. Other factors positively related to defaults were being divorced, being separated or being an independent student at the time of taking the loan. Factors with no relationship to default included age, sex and cumulative loan size.

The Kuch Report was based on over 25,000 student loan records and used more sophisticated analytical techniques than the FISL study, but reached similar conclusions. The best single predictor of default in the Kuch Report was that of being black. The risk was also high for divorced or separated students of low income families at the time the loan was taken. The study found that delinquency and default rates were not necessarily higher among those with large amounts of GSL debt. No further analysis was conducted, however, to determine the relative resources available to these borrowers during repayment.

Limitations of Studies. Both studies have serious limitations. First, both depend on correlation, thereby eliminating causal relationships between the variables--that is, a particular factor cannot be said to cause a particular result. Second, there are several potential factors influencing default behavior which are not included in the

studies. For example, no attention is given to different types of lenders, due diligence procedures by lenders, or counseling of borrowers. Third, the existing studies were undertaken using FISL records for 1974. Hence, the role that state guaranty agencies have played in improving default rates is not recognized nor is the recent allowance for a period of deferment during repayment to assist students who might otherwise be forced to default. In addition, revised bankruptcy laws have been enacted. Finally, other subsequent revisions in the law have resulted in large numbers of defaulted student loans being referred to credit agencies.

Comparison of Studies. The Cresap Study for the Department of Education, as previously indicated, involved collecting borrower characteristics from 510 student records in nine schools. These institutions were proprietary schools and traditional higher education institutions that were direct lenders in the program. The eight variables collected included: age, marital status, sex, race, adjusted gross income, financial dependency on parents, cumulative amount of loans received, and whether the student graduated or withdrew from the school.

The statistical technique used was a simple correlation (r). By this approach, a perfect relationship is expressed as ± 1 ; no relationship is expressed as 0 . The square of r

(r^2) expresses the amount of variance which can be predicated in one variable if the value of another is known. Thus, with $r = .20$, knowing the value of one variable would allow one to guess the value of a second variable at a 4 percent better-than-chance rate. At $r = .9$, the odds of a correct prediction are increased by 81 percent.

This interpretation of r brings to light the rather limited value of the correlations reported in the first study (see Table 1). These results suggest that the prediction of default at the time of making a loan are improved by only 10 percent from chance by knowing the borrower's characteristics. Stated differently, 90 percent of the factors which are associated with defaults of loans are not identified in this study.

The Kuch Report provides more extensive results than the Cresap Study, partly because a much larger sample and more powerful statistical techniques (which can identify combined effects of variables) were used. More than 25,000 records, nearly equally divided among former university and college students, former junior college students, and former specialized and vocational school students, were reviewed (see Table 2 for a summary of the results from this regression analysis). Kuch's results indicate a stronger relationship among variables than indicated in the Cresap Study. Nevertheless, there are no real conflicts between the conclusions of the two studies, although they do define

some variables slightly differently. For instance, proprietary schools are defined in terms of accreditation in the Kuch Report. Also, because of different definitions applied at the time the data was collected, independent student status in the first study is probably equivalent to married student status in the second.

TABLE 1
CORRELATES OF STUDENT LOAN DEFAULT

<u>Variables</u>	<u>r</u>	<u>r</u> ²
Withdrawal from school	.23	.0529
Being black	.32	.1024
Independent student	.11	.0121
Family income of borrowers	.08	.0064
Age of student	0	0
Divorced or separated	.10	.0100
Sex	0	0
Cumulative loan amount	0	0
Being black and nongraduate	.26	.0676
Being black and low-income	.21	.0441
Being black and having large cumulative loans	.19	.0361

SOURCE: Cresap Study.

TABLE 2
CORRELATES OF DEFAULT RATES

<u>Variables</u>	<u>r</u> ²
Black	.1390
Divorced or separated	.1488
Proprietary schools:	
Association of Independent Colleges and Schools accredited	.2217
National Home Study Council accredited	.1653
National Association of Trade and Technical Schools accredited	.1367
Black families, separated and divorced	.1261
Community college student	.0797
Specialized and vocational school	.0596
Minorities other than blacks	.0313
Married at time of loan	.0354
Adjusted income under \$6,000	.0828

SOURCE: Kuch Report.

The Department of Education has not made policy decisions based on the results of these studies, mainly because of the above-noted reasons. Although the studies provide some clues as to "who" (that is, what type of borrower) is more likely to default on a student loan, they do not address the more crucial concerns of "why" student borrowers default.

The reasons why students do not repay their loans are difficult to quantify. For example it may be that the quality and quantity of counseling that students receive prior to loan disbursement has a significant affect on repayment behavior. Personal attitudes towards borrowing, family histories, and numerous other social and psychological factors may also be determinants of student attitudes towards their repayment obligations. Currently, there is no reliable information that adequately explains why some students repay their loans and others default.

Although in the studies cited above race is cited as a factor associated with a higher likelihood of default, it is quite probable that race itself serves as a proxy for a number of social and economic factors. Knowing that a borrower is black or white does not provide any real insight into their future repayment behavior. The same is true of students at proprietary schools. While the data in the Kuch Report indicates that attendance at a proprietary institution is related to default, the reasons "why" these students default at a higher rate once they leave school are unknown.

In order to gain a greater understanding of the impact of eliminating the in-school interest subsidy on borrower behavior, the relative importance of debt burden in determining "why" students default on their Guaranteed Student Loans must be analyzed. An understanding of the impact of increased levels of indebtedness is crucial to this effort because all of the proposals to eliminate the subsidy will increase the total amount of student debt.

Analysis of State Dump File

The basic data source employed in this analysis is the State Guarantee Agency Loan Guarantee Record Dump. The data collection effort to develop this file was carried out as a joint project of the National Council of Higher Education Loan Programs (NCHELP) and the U.S. Department of Education in 1980 and 1981. The Commission, in cooperation with NCHELP and the Department of Education, has performed a detailed analysis of the data file.

The creation of this tape represents a major stride in efforts to better understand the impact of the GSL program on borrowers and will prove very valuable to future efforts to research and gain better understanding of the GSL program. Never before has a comprehensive national student borrower data base been available with which to assess or develop policy options.

The data tape consists of the records of individual student borrowers and contains information on state of

residency, school, anticipated graduation date, originating and current lender, dates of the loan, amount of loan, cumulative debt, and the most recent status of the loan.

The quality of the data and the data elements submitted for each borrower varied greatly from state to state. This was due in part to the differences in recordkeeping practices used by various guaranty agencies and to the fact that there are no national standards for the collection of data on GSL borrowers. In order to assemble the highest quality data file for use in these analyses, extensive edit checks were performed on the borrower records. Only those records that contained certain key pieces of data and whose data fell within acceptable ranges were included in the analysis. From a total of nearly 5 million records a core of 2.7 million were maintained for study purposes.

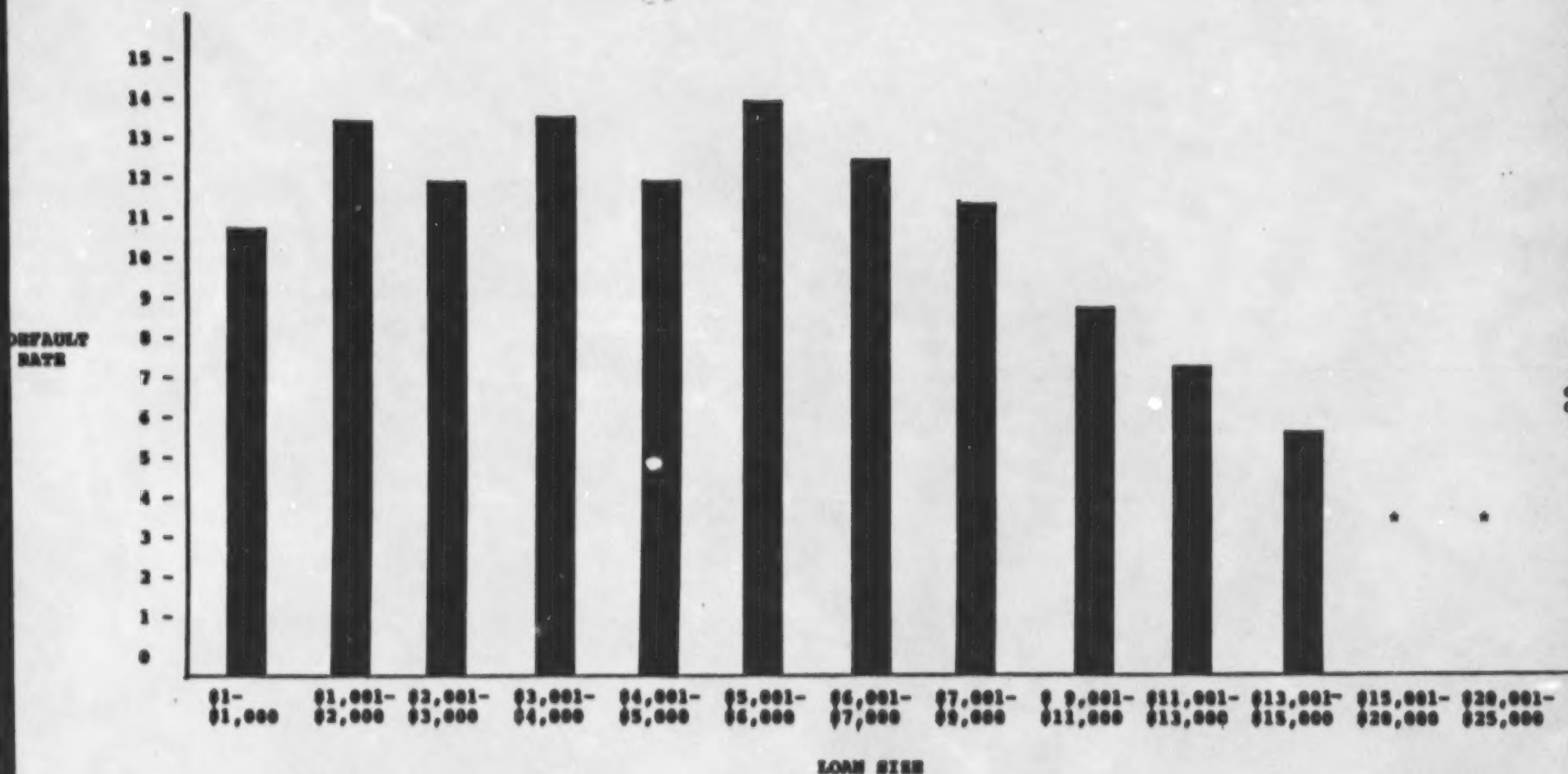
For purposes of the study of the GSL in-school interest subsidy, only a portion of the results from the analysis of the state dump tape will be reported here.

There is little evidence that a positive correlation exists between the size of cumulative loan debt and the propensity of borrowers to default (see Chart 1). On the surface, it even seems that there may be a negative correlation--that is, those with the highest debt burdens (\$9,001) are the least likely to default on their payments. However, there is a likely explanation for this phenomenon.

CHART 1

PERCENTAGE OF LOANS IN DEFAULT BY SIZE OF LOAN

(total number of loans = 1,273,380)



*Insufficient data available.

SOURCE: Applied Systems Institute, "Study of Guaranteed Student Loan Default Rates," prepared for the National Commission on Student Financial Assistance, August 1982, p. 19.

Borrowers who leave school with the highest amount of debt are most often those who have completed four years of postsecondary work and additional years of postgraduate study. These borrowers have the highest earnings potential of the borrower population. When they leave school and enter repayment, it is probable that they will be earning a great deal more than others who have not completed as much schooling. Further analysis of the state dump tape revealed that borrowers at two-year and proprietary institutions have the greatest likelihood of default.³⁴ This despite the fact that since these students spend only one or two years in school their average loan size is considerably smaller than their four-year and graduate school counterparts. The earnings potential for these students is, simply, lower than for those who complete four-year and/or graduate programs. This finding was then confirmed through an analysis of loan repayment status according to the last academic year reported by the borrower. Borrowers who last reported that they were in their first or second year of postsecondary study defaulted at much higher rates than the national average (16.89 percent for first year and 14.55 percent for second year students). This goes a long way towards explaining why it is so difficult to examine propensity to default only in terms of cumulative loan debt.

³⁴The default rate for proprietary students and two-year college students was 17.51 percent and 18.57 percent, respectively, compared to an overall rate of 12.16 percent.

Another analysis was performed to examine the relation between the rate of default and the time that had passed between the issuance of the last loan and the borrower's declaration of default. The number of years elapsed between the time of the last loan and the occurrence of default seem to be slightly related (see Chart 2). The elevated default rates for borrowers who are only three to four years removed from their last loan indicates that default occurs more often in the first year of repayment. In general, borrowers do not begin repayment until approximately two years after the date of their last loan. After receiving their last loan, borrowers complete a full year's schooling and have at least a six-month grace period before repayment begins. Borrowers listed here as three years removed from their last loan are likely to be in their first year of repayment.

This increased propensity for borrowers to default in their first years of repayment confirms anecdotal evidence obtained from officials within the Education Department and guaranty agencies.

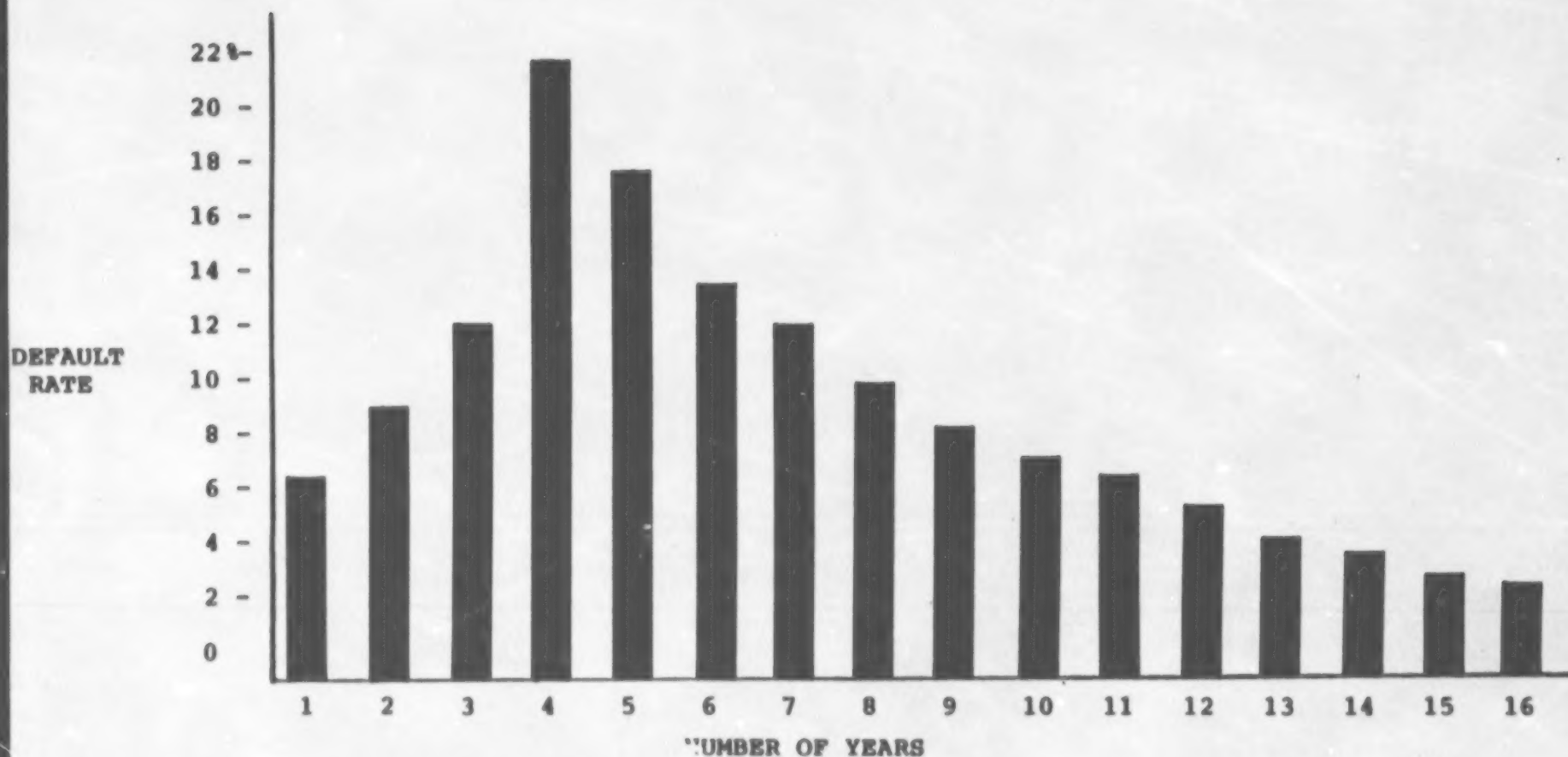
Study of Debt Burden (EPRI Model Report)

Given this background data on GSL borrowers, the Commission analyzed the potential impact of increasing borrower indebtedness by eliminating the in-school interest subsidy. This analysis, presented below, develops estimates of the increase in repayment burden that would need to be borne by borrowers in a nonsubsidized GSL program. While it

CHART 2

PERCENTAGE OF DEFAULT BY ELAPSED TIME*
Date of Last Loan to Current Status

(total number of loans = 741,209)



*Elapsed time represents time between date of last loan and date loan went into default.

is possible to comment on the impact of increased burden during the traditional (after schooling) repayment period, it is not possible to fully estimate the effects of proposals requiring in-school payment. However, those involved with the student loan program (lenders, guaranty agency officials, and Education Department personnel) all believe that borrowers will have a great deal of trouble attempting to meet the demands of in-school payment schedules. Thus, this impact analysis is limited to the accrual and deferral option and the proposal requiring students to borrow the amount of their in-school interest.

The model of discretionary income as it relates to loan repayment burden was developed for the Education Department in 1977 by the Education Policy Research Institute (EPRI). The purpose of the model is to express loan payment burden as a percentage of the discretionary income of borrowers once they leave school. According to the model's authors:

There is no generally accepted definition of discretionary income as it applies to student aid or to general economic analysis. . . . As a basic rule, discretionary income is the amount of current resources which remain for a family's or an individual's use after taxes and basic living expenses are deducted. For the purpose of this [analysis] we define discretionary income as:

Discretionary Income = (Total Earnings) - (Taxes) -
(Basic Living Expenses)³⁵

³⁵Education Policy Research Institute, "Discretionary Income and College Costs," prepared for the National Commission on Student Financial Assistance, August 6, 1982, p. 3.

Likewise, the designers of the model point out that there is no hard and fast rule detailing the proper amount of discretionary income that a borrower (or his or her family) should or could devote to repaying student loan debt. It appears reasonable and logical to assume that borrowers should not be expected to devote more than 50 percent of their discretionary income to the repayment of student loan debt. This will leave a reasonable portion of discretionary income available for emergency expenses, savings, cultural or recreational activities, and, importantly, to pay for other consumer debts incurred by the borrower (for example, auto loans, mortgages, business-related loans). The remaining portion of discretionary income may also cover unexpected or emergency expenditures. Applying this rule of thumb, one can begin to assess the impact of proposals that would result in increased student loan debt burden.

Using a variety of data sources, the model's designers developed a simple table that shows the effects of certain amounts of student loan debt on 1981 college graduates for interest-subsidized loans once they enter repayment (see Table 3). Several caveats must be applied in studying this data:

- o earnings listed for student borrowers are reflective of those expected by college graduates;

- o nongraduates or those who have completed courses at less-than-four-year institutions may be expected to earn considerably less than the amounts shown;

- a college degree carries with it no guarantee of immediate employment regardless of salary;

- many factors, too numerous to name here, can severely affect the level of earnings attained, even by graduates five and ten years out of school;

- a \$63,000 earning rate for ten years after graduation may or may not obtain for the majority of graduates; and

- the table does not adequately address the issue of increased family size in later years.

As Table 3 illustrates, borrowers who incurred student loan debt of \$10,000 may be severely tested in their attempts to repay that debt since their payments will total 52 percent of their discretionary income (exceeding that 50 percent measure of reasonable debt). As noted earlier, borrowers are more likely to default during their first years of repayment.

Repayment Burden for Nonsubsidized Loans

Proposals that would result in the elimination of the GSL in-school interest subsidy will have a major impact on the size of the debt students acquire during their postsecondary careers. By requiring that the interest on student loans accrue during the in-school and grace period and then be added to the student's repayment obligation the total debt will be increased by \$2,700 for borrowers who total \$10,000 in Guaranteed Student Loans. On paper, this

appears to be significant in terms of the extra proportion of debt assigned to these borrowers (27 percent). The affect that such an increase will have on borrowers' ability to bear their debt burden can be examined through use of the discretionary income analysis described above.

Eliminating the in-school interest subsidy would have a potentially disastrous effect on the ability of student borrowers to meet the demands of repayment (see Tables 3 & 4). Asking students to devote 67 percent of their discretionary income to loan repayment as required by accrual and deferral plans, will have the effect of stretching a borrower's financial resources to, and likely beyond, its extreme. Expressed in terms of the proportion of discretionary income that must be devoted to repayment, the accrual and deferral plan increases the burden by nearly 30 percent.

It is entirely possible that this table understates the potential impact of increased repayment burden, because the borrowers being examined are assumed to be college graduates. As previously noted, the earnings potentials of those who do not leave school with a traditional four-year or graduate degree are significantly lower than those who achieve this goal. One can assume that for college graduates, the incidence of default may rise proportionately with the increase in repayment burden. For nongraduates this increase in default may be many times greater. Certainly, any cost savings realized under these proposals may be approached,

TABLE 3

ESTIMATED 1981 COLLEGE GRADUATES' DISCRETIONARY INCOME AND LOAN REPAYMENT OF INTEREST-SUBSIDIZED LOANS AT SELECTED DEBT LEVELS

Year Gradu- ation	Total Annual Earnings	Discretionary Income	<u>Annual Repayment and Loan Burden</u>			
			\$3,800 Debt 9%/10 yrs. Burden		\$10,000 Debt 9%/10 yrs. Burden	
1	\$13,300	\$ 2,900	\$578	20%	\$1,520	52%
5	28,840	10,400	578	6	1,520	15
10	63,840	32,900	578	2	1,520	5

SOURCE: Education Policy Research Institute, "Discretionary Income and College Costs," p. 14.

TABLE 4

ESTIMATED GSL REPAYMENT BURDEN AS A PERCENTAGE OF DISCRETIONARY INCOME ONE YEAR AFTER GRADUATION

(\$10,000 total GSL principal)

GSL Rule	Discretionary Income*	Annual Repayment (10-year plan)	Percent of Discretionary Income
Current law	2,900	1,520 [#]	52%
Accrual and deferral	2,900	1,930 [#]	67

*Based on an estimated earnings in the first year after graduation of \$13,300 (see Table 3).

[#]Total loan principal: \$10,000.

[#]Total value of loan principal plus accrued in-school interest: \$12,700.

equaled, or even exceeded by additional costs to the federal government should default claims rise at such a rate. Also, drastic increases in defaulted loans will seriously jeopardize the credibility and stability of the GSL program as a whole.

V. RECOMMENDATIONS: RETAIN THE IN-SCHOOL INTEREST SUBSIDY

The in-school interest subsidy is a crucial element of the Guaranteed Student Loan Program. It is a vital and irreplaceable aspect of the program's mission--to provide access to loan capital for persons seeking to finance their postsecondary education. As currently constituted, the program represents the single largest effort to assist students in financing their educational pursuits. Eliminating the in-school interest subsidy will seriously damage the program's ability to serve students.

All of the proposals to eliminate the interest subsidy carry with them significant cost savings for the federal government. However, these proposals must be examined in light of their impact on program operations, capital availability and student indebtedness before their merits can be judged. While the federal government may realize budgetary savings, especially in later years, should the subsidy be eliminated, other participants in the process will be forced to absorb additional expenses. In fact, the federal savings may not be nearly as large as forecast should borrower default rates rise as high as lenders and state guaranty officials have predicted.

Proposals that would require students to pay the interest that accrues on their loans while in school would cause major administrative problems for lenders, servicers, state guaranty agencies and secondary markets. Experience

with the PLUS Loan program and various other nonsubsidized student loan programs indicates that borrowers will encounter great difficulty in meeting payment obligations while they are still enrolled as students. The increased costs associated with servicing these loans and the difficulties that will arise in secondary market transactions involving such loans will discourage many lenders from continuing to participate in the GSL program, thus, inhibiting student access to loan capital.

Eliminating the federal payment for the in-school interest subsidy by requiring that interest be accrued and deferred by lenders until the repayment period is problematic. Lenders depend on the cash flow they receive through regular payment of in-school interest. Suspending this income until the repayment period will reduce lender profits on these loans as well as make them less attractive to secondary market purchasers. Again, the supply of GSL capital will shrink as lenders can be expected to withdraw from the program. Adding the amount of in-school interest to borrowers' repayment schedules will significantly increase their monthly obligations and could result in marked increases in defaults.

For all practical purposes, it is impossible to continue the Guaranteed Student Loan program as it is currently structured without the in-school interest subsidy. From an operational and administrative viewpoint, eliminating the subsidy would have a disastrous impact on the program. In

terms of the service that the Guaranteed Student Loan program provides to students, eliminating the subsidy would be quite undesirable. The potential reduction in capital availability and the impact of increased repayment obligations for those students who would be able to locate GSL capital would be in direct opposition to the goals of the federal student financial assistance programs.

RECOMMENDATION: The National Commission on Student Financial Assistance recommends that the Guaranteed Student Loan in-school interest subsidy be retained in its current form.

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